VanEck®

EM Debt: Playing Out, Not Played Out

By Eric Fine, Portfolio Manager

VanEck - Unconstrained Emerging Markets Bond UCITS

USD R1 Inc: IE00BYXQSJ74
USD I1 Inc: IE00BYXQSF37
USD I2 Inc: IE00BYXQSG44
USD M Inc*: IE00BYXQSH50
EUR Hedged I1 Inc: IE00BYXQSD13
EUR Hedged I2 Inc: IE00BYX22V58

Average Annual Total Returns (%) as of 31 May 2020

	1 Mo†	3 Mo†	1 Yr	3 Yr	Life
USD R1 Inc (Inception 12/6/14)	9.98	-9.75	-5.17	-1.17	-2.33
USD I1 Inc (Inception 20/8/13)	10.07	-9.54	-4.27	-0.36	0.69
USD I2 Inc (Inception 20/8/13)	10.08	-9.51	-4.19	-0.19	0.82
USD M Inc* (Inception 18/9/14)	10.05	-9.58	-4.46	-0.43	-1.46
EUR Hedged I1 Inc (Inception 6/10/15)	10.01	-10.56	-7.26	-3.07	0.28
EUR Hedged I2 Inc (Inception 22/08/17)	10.01	-10.57	-7.26	-	-3.96
50% GBI-EM/50% EMBI USD[1]	5.62	-4.69	1.29	1.82	2.70

* *Investment through authorized financial institutions only.*

† *Periods greater than one year are annualized.*

[1] *Life performance for the 50% GBI-EM/50% EMBI - USD benchmark is presented in U.S. Dollars (USD) as of Class I1 inception date of 20/8/2013*

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Fund Review

The VanEck Unconstrained Emerging Markets Bond UCITS (Class USD I1) gained 10.01% in May compared to a gain of 5.62 % for the 50/50 J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) local currency and the J.P. Morgan Emerging Markets Bond Index (EMBI) hard-currency index.

Turning to the market's performance, GBI-EM's biggest winners were Mexico, South Africa, and Colombia. Its biggest losers were Dominican Republic, China and Malaysia. The EMBI's biggest winners were Mexico, Argentina, and Colombia. Its losers were Sri Lanka, Venezuela, and Morocco.

Market Review

We outperformed our benchmark (50% J.P. Morgan EMBI-EM GD and 50% J.P. Morgan GBI-EM GD) by 439bp in May, with the fund (Class USD I1) up 10.01%. The details of the performance were very hopeful, in our view. Why hopeful? Overall, Angola (in USD), Mexico (in local), Argentina (in USD), Indonesia (in local) and South Africa (in local) were the big winners for the Fund in May. What is hopeful is that these performances point to: a) a reversal of the March liquidity panic; and b) the ongoing importance of country-specific developments. All of our winners have elements of both a reversal of panicked selling and country-specific positives, in varying degrees. Angola's rally was about prices driven by panic, combined with a very supportive official lending community (see our IMF takeaways) towards Angola. Argentina's rally was also set up by panic-driven prices combined with a country that is now clearly negotiating with creditors, not dictating terms. The rest—Mexico, Indonesia and South Africa—were largely up because they went down too much in March, but they also benefited from country-specific positives (such as high real interest rates) that our investment process is designed to capture. These contributors to performance are also hopeful, because the Fund increased its exposures here in March, so the overall thesis is arguably stronger now than it was then.

The team remains very bullish (still seeing more to go) following a "Buy of the Century" opportunity created by March's liquidity crisis. As a reminder: the Fund increased its Mexico (local) and Angola (USD) exposures in March and reduced its more defensive local currency exposures (such as the Czech Republic and Thailand). Those were explained in our previous monthlies. Most generally, the team continues to think that EM countries have the same basic fundamentals

that made them perform and attract inflows post-GFC. Lower leverage and higher real interest rates continue to characterize EM relative to DM. We believe There's even more stimulus from the DM countries in response to the current crisis than there was to the GFC. In contrast to EM, DM have even more leverage and lower interest rates, forcing them into more fiscal and monetary experimentation and supply. This money may flow to EM bonds, in our view, as happened post-GFC. Also, a lot of the DM stimulus for this current crisis is specifically aimed at stabilizing EM.

Babies were thrown out with the bathwater, in our view. We see a great number of EM bonds that were sold at prices reflecting a liquidity crisis. As that gets addressed, as economies stabilize and as COVID-19 naturally abates, there is upside in a number of situations in our opinion.

Rebounding growth data out of China (and much stronger employment data in the U.S.) point to a sharper economic recovery than the market had been pricing; combined with recent EM bond market and our fund performance, this seems to strengthen a bullish thesis. As the first to suffer from COVID-19 and/or the policy reaction to it, China is obviously key to watch. In May, China held its National People's Conference, at which a growth target was dropped, but a binding employment target was created (nine million new urban jobs). Fiscal stimulus was promised, but at approximately 3.5% (currently) is still looking prudent to us. We believe Total Social Financing is set to grow "significantly", giving a green light for more rate cuts. Through this, China's latest activity gauges (Purchasing Managers' Indices or PMIs) point a recovery that is uneven and faces strong global headwinds. The official manufacturing PMI stayed in expansion zone (50.6), but undershot consensus, while the new export orders PMI was outright contractionary (35.3). At the same time, the new orders PMI edged higher, the services PMI continued to improve and the Caixin manufacturing PMI—which has a larger share of small privately-owned companies—returned to expansion territory (50.7). So, green shoots are clearly there, but they may require policy support for quite some time—especially as the trade deal with the U.S. is once again under threat.

We end May with carry of 8.4%, duration of 5.4 and approximately 40% in local currencies. (We exclude Argentina from our carry calculation). Our largest exposures remain Indonesia (local), Argentina (USD), Mexico (local), Ukraine (USD and local) and South Africa (local). In May, as in April, our changes were minor and country-specific, consistent with our impression that selectivity is driving alpha. March was the month of bigger portfolio changes, during which we took advantage of liquidity-crisis selling.

Argentina saw key positive developments during May, consistent with our positioning. Basically, the market started seeing a sovereign that was negotiating with creditors, rather than a sovereign that was presenting "all-or-none" proposals. In particular, the government made a formal counteroffer to a key creditor group and extended its deadline for negotiations. More specific developments include the government's openness to paying past-due interest, as well as news reports distancing President Alberto Fernandez from his debt negotiator, Economy Minister Martin Guzman. The president is regarded, according to this line, as seeing the economic cost of a disorderly default as far higher than any savings.

We have communicated on a range of topics recently, so we don't explore new territory in this current monthly. Below are convenient links to our recent pieces:

- On why EM debt is currently a "Buy of the Century": VanEck Research: Sale of the Century
- On our takeaways from the April IMF meetings: IMF Spring 2020 Meetings - Dive Survive Revive or Differentiate
- Our recent Webinar: EM Debt: Back Up the Truck!
- Our recent Bloomberg radio interview: Eric Fine on Bloomberg Radio- Oil Collapse Benefits Some EM Countries

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Indonesia, Argentina, Mexico, Ukraine and South Africa. In almost all cases the "increases" were from price appreciation.

- We increased our hard currency sovereign and quasi-sovereign exposure in Argentina. The bulk of the increase in the Fund's exposure, though, was due to price appreciation, as the government improved its debt

restructuring offer and extended the deadline to finalize the negotiation process, which was well received by the market. We decided to buy a provincial bond because it looked extremely cheap in our view. All provincial bonds in Argentina are subject to restructuring (the government's order), but the bond in question was trading well below potential recovery values, which improved its technical test score.

- We also increased our local and hard currency quasi-sovereign exposure in Mexico. We bought one quasi-sovereign bond because the spread to the sovereign looked attractive, given the direct support from the government (which might increase further in the coming weeks). In terms of our investment process, this improved the bond's technical and policy test scores. The change in our local bond holdings was due solely to price appreciation.
- Finally, our hard currency sovereign exposure in Angola and hard currency corporate exposure in Ghana also went up—both due entirely to price appreciation.
- We reduced our hard currency sovereign exposure in Azerbaijan. The bond's spread-to-yield ratio was among the lowest in the portfolio—which means that it is driven more by global developments rather than by idiosyncratic factors—and this worsened the technical test score for the bond. We decided to sell it in order to fund other—more interesting and attractive—positions.
- Our local currency exposure in Uruguay and the Dominican Republic also went down—as a result of price changes.
- Finally, our hard currency corporate and local currency exposures in Belarus and Indonesia also declined. The changes were quite small and were due to price movements.

R-Squared is the percentage of a fund's movements that can be explained by movements in a benchmark index.

DXY is the U.S. Dollar Index that measures the value of the United States Dollar relative to a basket of foreign currencies.

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Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the U.S.-dollar, euro or yen). Emerging Markets Local Currency Bonds are bonds denominated in the local currency of the issuer. Emerging Markets Sovereign Bonds are bonds issued by national governments of emerging countries in order to finance a country's growth. Emerging Markets Quasi-Sovereign Bonds are bonds issued by corporations domiciled in emerging countries that are either 100% government owned or whose debts are 100% government guaranteed. Emerging Markets Corporate Bonds are bonds issued by non-government owned corporations that are domiciled in emerging countries.

Duration measures a bond's sensitivity to interest rate changes that reflects the change in a bond's price given a change in yield. This duration measure is appropriate for bonds with embedded options. Quantitative Easing by a central bank increases the money supply engaging in open market operations in an effort to promote increased lending and liquidity. Monetary Easing is an economic tool employed by a central bank to reduce interest rates and increase money supply in an effort to stimulate economic activity. Correlation is a statistical measure of how two variables move in relation to one other. Liquidity Illusion refers to the effect that an independent variable might have in the liquidity of a security as such variable fluctuates overtime. A Holdouts Issue in the fixed income asset class occurs when a bond issuing country or entity is in default or at the brink of default, and launches an exchange offer in an attempt to restructure its debt held by existing bond holding investors. Carry is the benefit or cost for owning an asset.

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